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In the Supreme Court of the United States

October Term, 1983

M & K FARMS, INC., A MONTANA CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. Does the Ninth Circuit's Majority Opinion conflict with and sanction a departure by the district court from this Court's requirement in *Botany Worsted Mills v. United States*, 278 U.S. 282 (1928) and pronouncement in *Lucas v. Ox Brush Fibre Co.*, 281 U.S. 115 (1930) that the fact-finder make a specific determination of the amount of salary which is reasonable for past and current services to be deducted by corporations in any given tax year pursuant to 28 U.S.C. §162(a) (1), where the principal shareholders are the corporate employees (the ultimate question of fact upon which the rights of the parties depend) when that question has been consistently raised, preserved and ignored during the administrative, judicial and appellate proceedings?

2. Does conflict exist in the federal judiciary regarding the propriety of implying an automatic dividend, in cases where the reasonableness of compensation to principal shareholder/employees is questioned, by the divergent treatments of the question by the Ninth Circuit in *Elliotts, Inc. v. C.I.R.*, 716 F.2d 1241 (9th Cir., 1983) and the Court of Claims in *Charles McCandless Tile Service, Inc. v. United States*, 422 F.2d 1336 (Ct.Cl., 1970), creating confusion in this area of the law (as was demonstrated by the Ninth Circuit Majority Opinion's failure in this case to follow its own rule) which should be clarified and resolved by this Court?

PARTIES TO LITIGATION

All parties to the litigation appear in the case title.

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In the Supreme Court of the United States

October Term, 1983

No.

M & K Farms, Inc., A Montana Corporation, Petitioner

v.

United States of America

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

OFFICIAL AND UNOFFICIAL REPORTS OF OPINIONS BELOW

The opinion of the Court of Appeals is found at *M & K Farms, Inc. v. United States,* CA No. 82-3588 (9th Cir., 1984) (Unpublished per Ninth Circuit Rule 21) (*See* Appendix at 10a to 16a). The decision of the district court is found at *M & K Farms v. U.S.,* 556 F.Supp. 50 (D.Mont., 1982) (*See* Appendix at 1a to 9a).

JURISDICTION

a. The date the Opinion of the Ninth Circuit in this case was January 12, 1984.

b. The date of the Order denying the Petition for Rehearing and the En Banc Suggestion was February 24, 1984.

c. The statutory provision believed to confer jurisdiction on this Court to review the judgment is 28 U.S.C. §1254(1).

STATUTE AND REGULATIONS INVOLVED IN THIS CASE

26 U.S.C. §162(a)(1):

> "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> "(1) A reasonable allowance for salaries or other compensation for personal services actually rendered;
>
> • • • •."

Treas.Reg. §1.-612-7(a) (1954):

> "• • • The test of deductibility in the case of compensation payments is whether they are (1) reasonable and (2) are in fact payments purely for services."

STATEMENT OF CASE

This case is a tax refund suit seeking reimbursement from the Internal Revenue Service of $108,029.61, statutory interest and costs. Taxpayer paid an assessed deficiency for corporate tax due as a result of the Internal Revenue Service's disallowance of a portion of the 1974 and 1975 salaries paid Keith and Melvin Good, principal shareholder/employees of M & K Farms, Inc., Appendix at 3a to 5a; Findings of Fact Nos. 9-14. The Internal Revenue Service assessed the deficiency based on its opinion that any amount of compensation over $30,000 per employee per annum for 1974 and 1975 was unreasonable. Appendix at 5a; Findings of Fact No. 12. The district court's jurisdiction was invoked pursuant to 28 U.S.C. §§1340 and 1346(a)(1). After trial, the district court concluded the taxpayer had not established the opinion of the Internal Revenue Service erroneous and inferred the salary payments were for something other than "services actually rendered". Appendix at 8a and 9a; Conclusion of Law Nos. 9 and 11. The district court's determination was affirmed by the Majority Opinion of the Ninth Circuit Court of Appeals. Appendix at 10a *et seq.;* Majority Opinion.

The district court failed to make a specific Finding of Fact declaring what compensation would be reasonable for personal services actually rendered to taxpayer by Keith and Melvin Good from 1968 to 1975 and therefore failed to decide the ultimate question of fact presented by taxpayer. The Majority Opinion of the Ninth Circuit Court of Appeals upheld the district court's judgment by allowing the *implication* of a factual determination of unreasonableness from the district court's holding. Appendix at 11a to 12a; Majority Opinion of the Ninth Circut. Judge

Boochever, dissenting from the Majority Opinion of the Ninth Circuit, found the district court's conclusion to be lacking support. Judge Boochever would have remanded for specific factual determinations "as to whether all or part of the amount in excess of the $30,000 per man allowed by the district court in 1974 and 1975 constituted compensation for services in prior years, and therefore was reasonable compensation." Appendix at 16a; Dissenting Opinion. Judge Boochever noted the question of compensation for past services had been consistently raised by taxpayer at all judicial levels. Appendix at 14a; Dissenting Opinion.

M & K Farms, Inc. is a Montana family farm corporation owned primarily by Keith and Melvin Good(hereinafter "the Goods") which began continuous existence in 1968.[1] The principal employees of taxpayers were the Goods. The Goods made all decisions for taxpayer; en-

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[1] All shares of the taxpayer are held by the Goods and their family members or by trusts for their benefit. Melvin Good's and Keith Good's percentage ownership of the corporate stock was never equal even though salaries paid these employees were identical. The corporation came into existence when both Goods consolidated their individual and partnership land and farming equipment. The Goods placed all their farming and personal business assets under corporate ownership in 1968 and received stock in exchange. The corporate taxpayer was formed primarily as an estate vehicle for passing corporate stock instead of directly passing and dividing the family land after Melvin Good's death. Melvin Good had a previous unpleasant experience in his parents' estate because the land itself was divided (causing a serious family feud). Melvin Good wished to avoid a similar dispute at his death. At the time of trial, Melvin Good was 72 years old and had been a farmer on his own land for over 50 years. Keith Good, his son, began working for his father part time when he was 9 years old and continued as his father's partner after his formal education was completed.

tended their personal credit for taxpayer's benefit; and were solely responsible for taxpayer's extraordinary agricultural success.[2]

At trial, unrebutted expert testimony established a common farm business practice of adjusting salaries which overcompensated in good years to make up for undercompensation in poor years due to the cyclical nature of agriculture business.[3] The compensation paid the

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[2] From 1968 to 1975 taxpayer doubled its acreage; doubled grain inventories; returned 19% on equity at book value in 1974 and 27.5% in 1975 or increased net worth by 70.9% per year from 1968 to 1975 after payment of the contested salaries; and, had yields which were 126% for winter wheat and 133% for barley of the two county average for marginal returns of farmers in their area. This success was due to the Goods hard work, long hours and superior farming methods. During the relevant period, corporate debt remained constant. The Goods also obtained a marginally higher grain price for the sale of taxpayer's grain. In addition, the efforts of the Goods allowed a dividend to be declared in 1974 of 6% of book value or $11,646 which was paid in 1975.

[3] In today's farming business environment, regardless of the services and methods employed by farmers, there are good years and bad ones due to important factors beyond the operator's control (*i.e.*, weather, market price and current rate of interest). Thus, a farmer will experience severe undercompensation in the bad years which he attempts to correct by adjusting his compensation upward in those years which allow a reimbursement for those undercompensated years of work without jeopardizing the financial integrity of the farming unit. This adjustment takes place regardless of the business form chosen by the farmer. Dr. Luft, an agricultural economist, analyzed the Goods' 1974 and 1975 compensation in comparison to a sharecropper/lessee (who owned no land or equipment) and found that a sharecropper would receive net income of $158,784 in 1974 and $164,661 in 1975 for only farming without any of the risks of land ownership. Thus, had the Goods been mere tenants (not having risked their per-

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Goods averaged approximately $30,000 per year per man from 1968 to 1975 if the contested salary payments are included in the computation.[4] Appendix at 2a and 4a; Findings of Fact Nos. 4 and 9. The salaries paid the Goods in the questioned years alone approximate what most farmers would have earned for their personal services based upon the production of M & K Farms.[5]

The district court *inferred* the payment of a dividend to the Goods in 1974 and 1975 by concluding the reason for the amounts received by the Goods over and above $30,000 per year per man was for something other than "services rendered" taxpayer.[6]

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sonal credit and ownership for the benefit of the corporation) they would have received two-thirds of the gross crop or $79,392.37 apiece in 1974 and $82,330.79 apiece in 1975. The same kind of adjustment a sharecropper experiences in good years can only be experienced by the employees of a farm corporation through a substantial increase of salary in good years which takes into account undercompensation for the work they performed in poor years. Judge Boochever recognized, "(u)nrebutted expert testimony, however, established that it is common practice in farming to make up for years of inadequate compensation by generous salary payments in prosperous years." Appendix at 15a; Dissenting Opinion.

[4] The Internal Revenue Service's opinion was that $30,000.00 per year per man was a reasonable salary for both years 1974 and 1975 without adjustment for inflation or change in farm production and prices. This is almost exactly the average amount which taxpayer paid each of the Goods as compensation from 1968 until 1975.

[5] See footnote 3 above.

[6] Since this is a corporation, any payment to the Goods must necessarily be either salary for services or a dividend on their investment based on their ownership of stock. Thus, as a syllogistic necessity, the district court's conclusion that any payment over and above $30,000 per year per man was for "factors other than 'reasonableness' and for compensation for services actually rendered" taxpayer (Appendix at 8a; Conclusions of Law No. 9) necessarily demonstrates that the district court presumed an automatic dividend as to the excess.

In 1970, the Court of Claims established a rule of law which required the automatic presumption of a dividend (regardless of the reasonableness of the compensation paid) based upon the absence of dividends declared and paid. *Charles McCandless Tile Service v. United States*, 422 F.2d 1336 (Ct.Cl., 1970). The Ninth Circuit has recently rejected this rule and instead has legally concluded that 26 U.S.C. §162 (a)(1) requires the lower courts only to determine the reasonableness of the compensation itself as the sole test of deductibility. *Elliotts, Inc. v. C.I.R.*, 716 F.2d 1241 (9th Cir., 1983). In this case, the Majority Opinion of the Ninth Circuit allowed the district court's use of an *inference* of an automatic dividend to stand without determining the reasonableness of the compensation paid the Goods over the relevant period therefore not following their own decision in *Elliotts, Inc., supra.*[7]

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[7] The Majority Opinion in the Ninth Circuit failed to recognize the district court's *inference* (see footnote 6 above) necessarily *implies* a dividend to the Goods for amounts paid in excess of $30,000 per year per man. Appendix 12a *et seq.*; Majority Opinion. While it follows as a syllogistic necessity from the district court's *inference* that the excess payments were for reasons other than services rendered by the Goods that the district court *implied* the excess payments to be dividends, it does not necessarily follow that the district court *implied* a finding of fact that the salaries actually paid were "unreasonable" over the period. In fact, the district court never reached that question but stopped it's inquiry short by implying an automatic dividend. Therefore, the Majority Opinion has sanctioned application of the *McCandless* automatic dividend doctrine in derogation of the rule in the Ninth Circuit under *Elliotts, Inc.* This point demonstrates the absolute confusion of the federal judiciary in this troubling area because two different rules of law are being applied without a definitive statement of the correct test for deductibility under 26 U.S.C. § 162(a)(1).

ARGUMENT

A. It Is Necessary For The Trier Of Fact To Specifically Find And Determine The Amount Of Compensation Which Is Reasonable For A Corporation To Pay An Employee For Current And For Prior Services When These Questions Are Raised By The Taxpayer. In The Absence Of Such A Specific Finding, The Judgment Is Defective As A Matter Of Law.

This Court ruled in *Botany Worsted Mills v. United States*, 278 U.S. 281, 289-290 (1928) that a finding on the ultimate fact was necessary to support a decision where the ultimate fact does not follow as a necessary inference from the record. In *Botany Worsted Mills*, this Court reversed the Court of Claims' judgment that the Mills was entitled to a deduction for salaries paid to directors because the Court of Claims failed to make a specific finding that the Mills proved the dissallowed compensation an ordinary and necessary business expense. This Court reversed the Court of Claims' judgment outright because the Mills failed to request a remand for additional factual findings on the ultimate question of the reasonableness of the compensation for services rendered (*Id.* at 289, footnote 7) and because the Court of Claims record did not contain sufficient facts for the taxpayer to have met it's burden to prove the compensation paid was reasonable. *Id.* at 292-293. In the absence of findings which supported a conclusion that the disallowed compensation was reasonable for services rendered, this Court found the Court of Claims' judgment defective as a matter of law.

The holding of *Botany Worsted Mills* therefore requires the trier of fact to make a specific determination

of what is reasonable compensation where salaries are deducted by corporate taxpayers as "ordinary and necessary" business expenses under 26 U.S.C. §162(a) (1). In the case now under consideration, the district court never specifically made a determination of the salaries' reasonableness despite substantial evidence elicited at trial which would allow such a determination and despite taxpayer's repeated requests for such a determination.[8] The district

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[8] Nowhere in the district court's Findings of Fact is the reasonableness of the salaries determined. In the district court's Conclusions of Law the trier of fact determines, as a matter of law, that the taxpayer has not proved the Internal Revenue Service's opinion of reasonable salaries erroneous. The district court's conclusion is based on using only those factors which support the Internal Revenue Service's opinion of reasonable compensation and ignoring the rest of a substantial body of evidence. See Appendix 9a; Conclusion of Law No. 11. By requiring the taxpayer to first prove the Internal Revenue Service erred in it's opinion of reasonableness without actually and specifically determining what is reasonable compensation for current and past services, the district court has placed an impossible burden on taxpayer. The first question which the district court is obligated to affirmatively consider is the reasonableness of the compensation over the period. It is only with this affirmative determination that the district court can logically examine the soundness of the Internal Revenue Service's opinion and therefore determine if taxpayer has met its burden to prove the Internal Revenue Service's opinion erroneous.

The Majority Opinion of the Ninth Circuit found an *implied* finding of unreasonableness from the district court's conclusions. The Majority Opinion assumes the district court has made a factual determination of the amount of salaries which were reasonable to pay the Goods. However, such an *implication* of a finding of unreasonableness does not logically follow from the Findings of Fact which were present. (See footnotes 6 and 7). The Ninth Circuit Majority Opinion concludes that the district court *must have "found"* that the salaries paid were unreasonable because the district court noted that the extra compensation in a closely held farm corporation was

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court therefore failed to decide the ultimate question in this case and since the ultimate fact upon which the rights of the parties are dependent cannot be necessarily inferred from the findings which are present, the district court's judgment is defective as a matter of law. The district court's decision conflicts with *Botany Worsted Mills v. United States, supra* and the Ninth Circuit Court of Appeals Majority Opinion sanctioned this departure from precedent of this Court.

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"suspect" and therefore a disguised dividend was present. The Majority Opinion's *implication* of a finding of "unreasonableness" by the district court was based upon the lack of a *written* consistently applied bonus program and written corporate minutes requiring a monthly payment of $2,000 per man without a written statement in the minutes that bonuses were paid to compensate the Goods for undercompensated prior years. However, it does not necessarily follow from these factors alone that the salaries paid the Goods were unreasonable. The body of the uncontradicted evidence showed a meeting was held at year end and it was decided to pay the Goods for their undercompensated services in prior years by paying a substantial bonus above the monthly minimum compensation. This action of the Board of Directors' in making this decision to fairly compensate the Goods for their years of undercompensated hard work was approved in the minutes at the end of the year as all informal actions of the Board of Directors' for this family farm corporation were approved. The district court's err and the Majority Opinion of the Ninth Circuit's fallacy was a failure to recognize the threshold question—an independent review and determination of the reasonableness of the compensation by the trier of fact of initial impression is required. Such an independent review of this matter was not conducted or considered by the district court since it misunderstood the taxpayer's true burden of proof to first establish that the compensation paid was reasonable. The record supports that the taxpayer met this burden and was not refuted because the Internal Revenue Service and the district court failed to consider the prior years of undercompensation in their opinion of reasonableness but rather took the years 1974 and 1975 standing alone.

This Court ruled in *Lucas v. Ox Brush Fibre Co.*, 281 U.S. 115 (1930) that a corporation could deduct compensation for past undercompensated services in the year that such additional compensation was actually paid. In so ruling, this Court firmly established that compensation paid by a corporation in a particular year may include compensation for years where an employee's services have not been adequately compensated. *Id.* at 119. Thus, where a claim of past undercompensation is made by the corporate taxpayer, the factfinder is required to determine the reasonableness of the compensation received by the employee over the entire period claimed to be compensated by the disputed salary.

In this case, the district court failed to specifically determine the amount of compensation in the disputed payment which compensated the Goods for past services despite the issue having been consistently raised at all levels and the taxpayer's presentation of substantial evidence on this question. *See* Appendix at 14a; Dissenting Opinion. Such a failure conflicts with this Court's decision in *Lucas v. Ox Brush Fibre Co., supra* and this conflict was sanctioned by the Majority Opinion of the Ninth Circuit.

Thus, a reading of *Botany Worsted Mills v. United States, supra* and *Lucas v. Ox Brush Fibre Co., supra* establishes a rule requiring the factfinder to make a specific determination regarding the reasonableness of the salary paid by a corporate taxpayer over the entire period where a claim of partial compensation for past services is made. Since the district court failed to make such a factual determination and this failure was sanctioned by the Ninth Circuit, the case should be remanded. In the alter-

native, this Court can reverse this case outright in favor of the taxpayer by determining on the record that the compensation paid over the period was reasonable in that it averages approximately what the Internal Revenue Service said would be reasonable compensation for the two years the district court did consider.[9]

B. A Conflict Exists Between The Court Of Claims And The Ninth Circuit Regarding The Implication Of An Automatic Dividend In Reasonable Compensation Cases Which Has Confused This Area Of Law In The Federal Judiciary. This Court Should Resolve The Question And Clarify The Rule.

In *McCandless Tile Service v. United States*, 422 F.2d 1336 (Ct.Cl., 1970) the Court of Claims held a dividend must be implied when no return on investment is paid shareholder/employees regardless of whether the con-

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[9] The evidence of the taxpayer that the salaries for 1968 to 1973 were undercompensation was noted by the Dissenting Opinion of Judge Boochever who specifically found the Internal Revenue Services' opinion of $30,000 per year per man as reasonable bolstered the taxpayer's argument that the salaries paid were reasonable over the period. Appendix at 15a; Dissenting Opinion at footnote 1. The Majority Opinion rejected this position simply because the directors of M & K Farms failed to formally earmark a part of the sum for past services rendered by the Goods and formally failed to show what percentage of the compensation was attributable to each of the years involved. Such a view places form over substance and ignores the reality of the actual operation of a Montana family farm corporation such as the taxpayer in this case. The Goods did show what they were paid in the past; what was paid in the contested years; that these amounts were approved by a meeting of the Board of Directors as compensation for past services; and, that the average yearly compensation over the period (1968 to 1975) was what the Internal Revenue Service considered reasonable for each of the two years in it's analysis. *See also* footnote 4.

tested compensation is reasonable or unreasonable. The Ninth Circuit has recently rejected this rule in *Elliotts, Inc. v. C.I.R.*, 716 F.2d 1241 (9th Cir., 1983) holding that the true inquiry in 26 U.S.C. §162(a)(1) deductibility is the "reasonableness" of the contested compensation and that no dividends may be automatically implied. Since payments to shareholder/employees must necessarily either be dividends (a return on invested capital to shareholder/employee) or salaries paid them for services actually rendered, the above conflict in the law among the federal judiciary has created confusion which this Court should clarify.[10]

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[10] The district court and Ninth Circuit Majority Opinion in fact *implied* a dividend payment in this case. The Ninth Circuit Majority Opinion therefore failed to follow its own rule in *Elliotts, Inc.* demonstrating the utter confusion in this area of the law created by this conflict in the federal judiciary. The inquiry under *Elliotts, Inc.* is the reasonableness of the compensation paid over the period without requiring a dividend to be *presumed* to be paid to the shareholder/employees on their equity investment since the Ninth Circuit in *Elliotts, Inc.* determined that investors in a corporation could be logically satisfied with an increase in value of their investment without necessarily receiving a cash dividend as a return on their investment. (In particular, farming corporations require vast capital concentrations and investors would typically prefer their return reinvested to expand corporate land and equipment holdings.)

As one of its factors in determining whether compensation was reasonable, *Elliotts, Inc.* suggested that the trier of fact should determine whether an independent investor would be satisfied with the return on his investment even if he did not receive dividends in light of the salaries paid. The Ninth Circuit in *Elliotts, Inc.* required the trier of fact to determine the reasonableness of salary paid and not to skirt the issue by automatically implying the contested compensation was a dividend. In our case, the district court made such an *implication* by concluding the disparity of salaries in prior

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Taxpayer's position is that this Court should require the federal judiciary to determine the reasonableness of the contested compensation without allowing the *implication* of an automatic dividend. The inconsistency of treatments received because of the confusion created by this conflict is amply demonstrated by taxpayer's treatment as opposed to the treatment received by Elliotts, Inc.[11]

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years to the contested years raised an *inference* that the contested compensation paid the Goods was for factors other than services rendered. Since a payment to persons such as the Goods can only be a dividend or salary in the context of reasonable compensation, the implication of a dividend precluded the district court from determining the reasonableness of the compensation paid for services rendered by the Goods. This Court should clarify the law by requiring the adoption of a test which either demands the payment of dividends as a return on equity as an automatic consideration or looks solely to the reasonableness of the compensation for deduction purposes pursuant to 26 U.S.C. § 162(a) (1). *See also* footnote 7. Further *see also* Note, *Close Corporation: McCandless, The Automatic Dividend Rule, And The Dual Level Test,* 26 Stan.L.Rev. 441 (1974).

[11] The district court in this case found that the increase in profitability of M & K Farms was largely due to increased grain prices brought on by the Russian Wheat Sale during the contested years. Appendix at 3a; Finding of Fact No. 7. Elliotts, Inc. was a farm implement dealership which depended on agricultural trade for its profitability. The contested period examined by the Ninth Circuit in *Elliotts, Inc.* was for the same period as the compensation period examined in the instant case. Both cases involve agricultural concerns, the profitability of which was substantially increased in the questioned years because of extra capital available to farmers from the Russian Wheat Sale. This extra capital allowed farmers to make long-delayed purchases of equipment such as was sold by Elliotts, Inc. The taxpayer in Elliotts, Inc. was allowed to pay salary as reasonable compensation based on a bonus arrangement which tied salary strictly to the net profitability of the corporation but which in fact compensated for previous years'

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This Court should remand this case for specific factual findings and an affirmative determination of what constitutes the Goods' reasonable compensation for the period if it strikes down the *McCandless* automatic dividend rule and rules the *Elliotts, Inc.* formulation of the lower courts' inquiry into reasonable compensation which may be deducted pursuant to 26 U.S.C. §162(1) (a) is the correct inqury.

CONCLUSION

For the foregoing reasons, it is requested that this Court issue a Writ of Certiorari and summarily reverse this case outright by entering judgment in favor of taxpayer or remand this case to the lower courts for a specific factual determination of the amount of salary which would be reasonable compensation for the Goods for services performed for taxpayer from 1968 to 1975 without briefing. In the alternative to such summary action, it is requested that this Court issue a Writ of Certiorari and, upon further appropriate briefing and oral argument or by summary action after further briefing, reverse this decision outright by entering judgment in favor of taxpayer or remand this case to the lower courts for a factual find-

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undercompensated services necessitated by the poor agricultural economy. The Goods, who made the same determination at year end after paying expenses and holding back reserves for future operations, have not been allowed to be compensated for their prior years' undercompensated services to taxpayer. Thus, the disparity in treatment received by taxpayer in this case with that received by Elliotts, Inc. is a result of the confusion in this area.

ing of the amount of salary which would be reasonable compensation for the Goods for services performed for taxpayer from 1968 to 1975.

Respectfully submitted this 16th day of May, 1984.

Respectfully submitted,

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APPENDIX

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MONTANA
GREAT FALLS DIVISION

No. CV-80-35-GF

M & K FARMS, INC., a Montana corporation,
Plaintiff,

vs.

UNITED STATES OF AMERICA,
Defendant.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

(Filed September 22, 1982)

This matter came on for trial before the court without a jury on March 18, 1982. Thereafter, the court prepared proposed findings of fact and conclusions of law, and ordered both parties to file with the court and serve upon opposing counsel objections to those findings and conclusions. Both parties were then given an opportunity to file answers to the objections raised by the opposing party. Having received the evidence presented at trial, and having reviewed each party's objections and answers, the court now enters the following

FINDINGS OF FACT

1. This is a civil action for recovery of 1974 and 1975 corporate internal revenue taxes said to have been wrongfully assessed and collected by the defendant.

2. Plaintiff, M & K Farms, Inc., is a Montana corporation having its principal place of business at Floweree, Montana. Plaintiff operates farmlands devoted to the growing of grain in Cascade and Chouteau Counties, near Floweree.

3. Plaintiff is a family corporation with the stock being held either by members of the family or by certain trusts for the benefit of family members. The principal stockholders and managers of the corporation are Melvin Good and his son, Keith Good.

4. From 1968 to 1973, the plaintiff paid Melvin and Keith Good the following compensation for personal services rendered on the farm:

YEAR	MELVIN GOOD	KEITH GOOD
1968	$ 7,000	$ 7,500
1969	9,800	9,800
1970	9,000	8,400
1971	9,000	8,900
1972	12,032	12,032
1973	15,590	16,090

5. In a consent document dated December 8, 1973, and filed in lieu of an annual meeting, the Board of Directors of the plaintiff corporation passed a resolution setting the monthly salary for the corporate president, Melvin Good, and vice-president, Keith Good. That resolution stated in pertinent part:

> RESOLVED, that commencing with January 1, 1974, and until changed by Resolution of the Board of Directors of the Corporation, the salaries of the officers of this Corporation, payable in monthly installments, shall be as follows:

President	$2,000 per month
Vice-President	$2,000 per month

The $2,000 monthly salary was exclusive of the corporate pension and profit sharing plans, which provided an additional amount in deferred compensation.

6. Plaintiff declared its first dividend in 1974. The dividend, equal to six percent (6%) of the par value of each shareholder's stock, or $11,664, was paid out in 1975 to the shareholders of record.

7. External conditions, specifically the Russian wheat sale, resulted in a high market price for grain during part of the period at issue.

8. During the years 1974 and 1975, the plaintiff used the cash method of accounting and filed its federal corporation income tax returns on a calendar year basis reflecting the following income, taxable income, income tax liability, and tax due:

YEAR	GROSS INCOME	TAXABLE INCOME	TAX LIABILITY	TAX DUE
1974	$373,832.61	$19,742.36	$1,384.73	$1,056.73
1975	398,593.78	36,883.74	3,852.49	3,524.49

9. On its 1974 and 1975 federal corporation income tax returns, the plaintiff deducted as "ordinary and necessary expenses" the compensation paid to Melvin and Keith Good in the following amounts:

MELVIN GOOD	1974	1975
Salary	$80,000	$ 60,000
Pension Plan	8,000	6,750
Profit-Sharing Plan	12,000	10,125
	$100,000	$ 76,875

KEITH GOOD

Salary	$ 80,000	$ 60,000
Pension Plan	8,000	6,750
Profit-Sharing Plan	12,000	10,125
	$100,000	$ 76,875

10. On September 28, 1978, the plaintiff received from the Commissioner of Internal Revenue a notice of deficiency of income tax for the calendar years 1974 and 1975. The tax deficiencies complained of were in the following amounts:

Year	Deficiency
1974	$ 66,036.05
1975	41,993.56
	$108,029.61

11. The Commissioner of the Internal Revenue determined that only part of the deductions taken for compensation in calendar years 1974 and 1975 constituted "ordinary and necessary expenses." Accordingly, the Commissioner disallowed a portion of the 1974 and 1975 deductions claimed against the plaintiff's gross income, as follows:

Year	Total Compensation Paid Both Goods and Deducted by M & K Farms, Inc.	Deduction Allowed by IRS as to Melvin Good	Deduction Allowed by IRS as to Keith Good	Total Deduction Allowed by IRS to M & K Farms for Compensation Paid to Melvin & Keith Good
1974	$200,000	$30,000	$30,000	$60,000
1975	$153,750	$30,000	$30,000	$60,000

12. From the above finding of fact, and finding of fact 5, *supra,* it follows that for calendar years 1974 and 1975, the Commissioner allowed the paintiff to deduct as reasonable compensation $30,000 per year for salary and deferred compensation paid to Melvin Good, and $30,000 per year for salary and deferred compensation paid to Keith Good, as follows:

Salary	$24,000
Deferred compensation	6,000
TOTAL	$30,000

13. The income tax deficiency of $108,029.61, set forth in finding of fact 10, *supra,* was paid in full by the plaintiff. Following payment, the plaintiff filed its claims for refund with the Internal Revenue Service. These claims were disallowed by the defendant on January 11, 1980.

14. The pending suit was commenced on February 29, 1980. Plaintiff seeks a refund of the $108,029.61 income tax deficiency, which it paid in full. Plaintiff also seeks statutory interest and costs.

CONCLUSIONS OF LAW

1. This action arises under 28 U.S.C. §1340 and 28 U.S.C. §1346(a)(1). Jurisdiction vests in this court by virtue of these provisions.

2. In a tax refund suit, such as the one now before the court, the assessment made by the Commissioner of Internal Revenue is presumed correct, and the plaintiff must prove that the assessment was erroneous. *See, Lew-*

is v. Reynolds, 284 U.S. 281 (1932). *Wickwire v. Reinecke*, 275 U.S. 101 (1975). *See also, United States v. Janis*, 428 U.S. 433 (1976).

In cases involving the deductibility of compensation as an "ordinary and necessary expense", the plaintiff must also prove that the compensation paid was reasonable and was therefore a deductible business expense. *See, Nor-Cal Adjusters v. C.I.R.*, 503 F.2d 359, 361 (9th Cir. 1974); *Perlmutter v. C.I.R.*, 373 F.2d 45, 47-48 (10th Cir. 1967).

3. Plaintiff, M & K Farms, Inc., deducted from its 1974 and 1975 corporate taxable income certain compensation payments which it made to Melvin and Keith Good.

26 U.S.C. §162(a) sets forth the applicable legal standard for this case:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> > (1) a reasonable allowance for salaries or other compensation for personal services actually rendered.

4. The test set forth in 26 U.S.C. §162(a)(1) is two-prong. The compensation payments may be deducted if they are (1) reasonable, and (2) are for personal services actually rendered. 26 C.F.R. §1.162-7(a) (1981) is equally specific in its requirement that compensation payments are deductible under 26 U.S.C. §162(a)(1) only if they are "reasonable and are in fact payments purely for services."

Therefore, the burden of proof of deductibility lies with the plaintiff to show that the compensation paid to

Melvin and Keith Good was reasonable within the purview of the statute and regulations, and was for personal services actually rendered. Only then may the compensation qualify as an allowable deduction. *Nor-Cal Adjusters v. C.I.R., supra,* 503 F.2d at 362.

5. This case involves two types of compensation: (1) non-deferred compensation; and (2) deferred compensation.

The deductibility of non-deferred compensation, such as salary, is governed by 26 U.S.C. §162(a)(1). The deductibility of deferred compensation, such as pension and profit-sharing plans, is governed by 26 U.S.C. §404. The allowable deduction at the corporate level for both forms of compensation is limited to the amount which constitutes "a reasonable allowance for compensation for the services actually rendered." 26 C.F.R. §1.404(a)-1(b).

6. The issue of what constitutes "reasonable compensation" for a taxpayer to pay depends upon the circumstances of each case and the issue is one of fact which must be decided in light of all the evidence. *Pacific Grains, Inc. v. C.I.R.,* 399 F.2d 603, 605 (9th Cir. 1968), *citing Hoffman Radio Corp. v. C.I.R.,* 177 F.2d 264 (9th Cir. 1949). *See also Pepsi-Cola Bottling Co. of Salina, Inc. v. C.I.R.,* 528 F.2d 176, 179 (10th Cir. 1976).

7. In the case of a closely held corporation, where the stockholders are also the officers and employees of the corporation, the issue of reasonableness of compensation is related to the issue of whether deductible salary expenses are, in fact, a distribution of non-deductible corporate profits. *See Pepsi-Cola Bottling Co. of Salina, Inc. v. C.I.R., supra,* 528 F.2d at 182-83. Therefore, when

determining the reasonableness of compensation, a court should give special scrutiny to compensation paid by a closely held corporation, such as a family farm corporation. *Id.* at 179. *See also Perlmutter v. C.I.R., supra,* 373 F.2d at 49; *Stonebrook v. C.I.R.,* ¶80,522 P-H Memo T C (1980).

8. Plaintiff, by way of its own corporate resolutions, expressed its intent regarding the salaries for Melvin and Keith Good. *See Klamath Medical Services Bureau v. C.I.R.,* 261 F.2d 842 (1958). The Board of Directors of the plaintiff corporation resolved that the monthly salary for Melvin and Keith Good would be $2,000, or $24,000 per year. This amount was exclusive of any deferred compensation.

9. The total compensation paid to Melvin and Keith Good increased to $100,000 per man in 1974 and $76,875 per man in 1975. The sharp rise in total compensation paid to Melvin and Keith Good in 1974 and 1975 raises the inference that these payments were based on factors other than "reasonableness" and as compensation "for services actually rendered." *See Nor-Cal Adjusters v. C.I.R., supra,* 503 F.2d at 362-63. It appears that grain prices were unusually high during 1974 and 1975 as a result of unusual conditions in the wheat market.

10. The Commissioner allowed the plaintiff to deduct for the calendar years 1974 and 1975 $30,000 per year for Melvin Good and $30,000 per year for Keith Good. The $30,000 yearly amount includes (1) $24,000 in salary, which is what the Board of Directors of the plaintiff corporation resolved to pay Melvin and Keith Good; and (2) an additional $6,000 in deferred compensation.

11. Having considered the lack of an arm's length relationship between the plaintiff and Melvin and Keith Good, together with the sharp increase in their 1974 and 1975 compensation and the expressed corporate intent regarding their salary for 1974 and 1975, the court concludes that the plaintiff has not established that the determination of the Commissioner was erroneous. Therefore, the Commissioner's determination is upheld.

NOW, THEREFORE, IT IS HEREBY ORDERED that judgment be entered in accordance with these findings of fact and conclusions of law.

DATED this 22 day of September, 1982.

/s/ Paul G. Hatfield
United States District Judge

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 82-3588

D.C. # CV 80-35-GF

M & K FARMS, INC., a Montana Corporation,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appeal from the United States District Court
for the District of Montana

District Judge Paul G. Hatfield, Presiding

[Argued and Submitted November 9, 1983]

MEMORANDUM*

(Filed January 12, 1984)

Before: WRIGHT, KILKENNY, and BOOCHEVER, Circuit Judges.

M & K Farms, Inc. brought this refund suit to recover a deficiency assessed by the Commissioner for the tax years 1974 and 1975. The deficiency was assessed for the alleged payment of excessive salaries to the sole stock-

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*Per Ninth Circuit Rule 21, this disposition is not intended for publication and may not be cited as precedent in this circuit.

holders and officers of the corporation, Melvin and Keith Good.

The district court affirmed the Commissioner's deficiency determination. Taxpayer alleges: (1) that the court imposed an improper dual burden of proof; (2) that it improperly relied on a presumption that the Commissioner's assessment was correct; and (3) that the court's judgment was clearly erroneous and not supported by substantial evidence.

We find that each contention lacks merit and affirm.

(1) The district court held that the taxpayer had to show that the Commissioner's assessment was erroneous *and* that the compensation paid to the employees was reasonable. This holding was correct. *See United States v. Janis,* 428 U.S. 433, 440 (1976); *Roybark v. United States,* 218 F.2d 164, 166 (9th Cir. 1954). In a suit for a refund of taxes, "[t]he taxpayer has the burden of proving both that an overpayment of taxes was made and the amount of the overpayment." *King v. United States,* 641 F.2d 253 (5th Cir. 1981).

Contrary to taxpayer's assertion, these twin burdens do not create an insurmountable obstacle to recovery. In fact, if the taxpayer meets the second hurdle by showing that the compensation paid to the employees was reasonable, it necessarily follows that the Commissioner's assessment was erroneous.

Taxpayer contends that the district court erred in concluding that the Commissioner's assessment was reasonable without specifically finding that the compensation paid was unreasonable. While the court did not specifically find that the payments were unreasonable, it considered

all the evidence relevant to the question and that finding implicitly underlay its holding.

(2) Taxpayer confuses the presumption of correctness of the Commissioner's assessment with the burden of persuasion that it must bear in a refund suit. Taxpayer, in a suit for the refund of taxes paid, bears the burden of proving by a preponderance of the evidence that the tax paid was excessive. *See, e.g., Roybark v. United States,* 218 F.2d 164, 166 (9th Cir. 1954). This includes both the burden of production and the burden of persuasion. *Rockwell v. Commissioner,* 512 F.2d 882, 885 (9th Cir.) *cert. denied,* 423 U.S. 1015 (1975).

Taxpayer's argument that the court erred in assigning a presumption of correctness to the Commissioner's assessment depends upon a gross misreading of *United States v. Janis,* 428 U.S. 433 (1976), and *Helvering v. Taylor,* 293 U.S. 507 (1935). More fundamentally, however, it ignores the burden of persuasion that it must bear in a tax refund action and mischaracterizes the district court's decision.

The court did not hold that it was deciding for the Commissioner because of the presumption of correctness. It ruled, instead, that the "plaintiff has not established that the determination of the Commissioner was erroneous:" i.e., that the taxpayer did not meet its burden of persuasion.

(3) The district court's conclusion that the compensation paid to the corporate officers was unreasonable was a factual determination which must be upheld unless clearly erroneous. *Elliotts, Inc. v. C.I.R.,* 716 F.2d 1241, 1245 (9th Cir. 1983); *Pacific Grains, Inc. v. CI.R.,* 399 F.2d 603, 605 (9th Cir. 1968). There was sufficient evidence to

support the court's conclusion that the payments to the Goods were not reasonable compensation "for services actually rendered."

The compensation was more than six times the amounts previously paid for similar or identical services. It greatly exceeded the $24,000 per year designated as projected compensation by taxpayer itself prior to 1974. Bonus payments to owner-employees that are not "awarded under a structured, formal, consistently applied program generally are suspect." *Elliotts, Inc.*, 716 F.2d at 1247.

Finally, the court was not required to accept the taxpayer's *post hoc* rationalization that the increased compensation was designed to compensate the employees for inadequate salaries in prior years. *Pacific Grains, Inc. v. C.I.R.*, 399 F.2d 603, 606 (9th Cir. 1968).

That the commissioner found $30,000 reasonable compensation for services rendered in 1974 and 1975 does not mean that it necessarily was reasonable compensation for previous years' work. The board of directors did not earmark the salaries paid as being in part compensation for past services. *See id.* There was no showing what percentage of the compensation was attributable to each of the years involved. *See id.*

The taxpayer has the burden of proving that the high amounts paid were intended to compensate for services rendered in the past. *Id.* On these facts, we cannot find that the district court's conclusion that the amounts paid were not reasonable compensation for services actually rendered was clearly erroneous.

AFFIRMED.

M & K Farms v. United States
BOOCHEVER, Circuit Judge, dissenting.
(Filed January 12, 1984)

The taxpayer asserts that the compensation paid the Goods in 1974 and 1975 was reasonable because it was intended, in part, to make up for inadequate compensation paid to the Goods from 1968 to 1973, the first six years of the corporation's existence. This assertion, which was clearly raised in both trial and appellate courts, was not addressed by the district court. I believe remand is warranted.

It is well established that a corporation can compensate for services rendered in prior years and claim a deduction for the tax year in which payment is made. *See Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930). In determining deductibility of compensation paid to shareholder-employees, the primary focus of our inquiry is upon reasonableness of the payments, not compensatory intent. *Elliotts, Inc. v. C.I.R.*, No. 81-7173, Slip op. at 4682 (9th Cir. Sept. 26, 1983). The taxpayer, however, has the burden of showing that salary was intended to compensate for prior periods. *Pacific Grains, Inc. v. C.I.R.*, 399 F.2d 603, 606 (9th Cir. 1968).

From the creation of the corporation until 1975 the Goods were paid the following compensation for their services:

YEAR	MELVIN GOOD	KEITH GOOD
1968	$ 7,000	$ 7,500
1969	9,800	9,800
1970	9,000	8,400
1971	9,000	8,900
1972	12,032	12,032
1973	15,590	16,090
1974	100,000	100,000
1975	76,875	76,875

There was a conflict in the testimony as to whether the compensation paid the Goods prior to 1974 was adequate given the nature of their services. Unrebutted expert testimony, however, established that it is common practice in farming to make up for years of inadequate compensation by generous salary payments in prosperous years. This testimony distinguishes the case from *Pacific Grains, Inc.*, where the taxpayer's theory of compensation for prior years appeared merely as "an afterthought developed at a time when the reasonableness of compensation was already under attack." 399 F.2d at 606.

The Commissioner maintains that $30,000 per year, per man constitutes reasonable compensation to the Goods for their services in 1974 and 1975.[1] $30,000 per year closely approximates the average compensation actually paid to the Goods from 1968 to 1975. The amount actually paid potentially constitutes a reasonable level of average compensation given the extremely long hours worked by the Goods and the unusual productivity achieved by the corporation through their expertise. We need not decide, however, whether $30,000 would have been reasonable compensation for each of those years. The question which was not resolved by the trial court is whether the Goods were inadequately compensated during the 1968-1973 period, and, if so, whether any portion of the amount paid in 1974 and 1975 was paid as reasonable compensation for the earlier years. Accordingly, I would remand

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[1] The Commissioner asserts that $30,000 is reasonable compensation despite the fact it exceeds the taxpayer's projections of compensation for these years. Melvin Good testified that the taxpayer's projection of $24,000 per man was intended as a minimum salary figure. The Commissioner's position adds credence to this testimony.

for specific findings by the district court as to whether all or part of the amount in excess of the $30,000 per man allowed by the district court in 1974 and 1975 constituted compensation for services in prior years, and therefore was reasonable compensation.

Moreover, the district court did not have the advantage of this court's comprehensive treatment in *Elliotts, Inc.* of the various factors to be analyzed in determining whether payment made to shareholder-employees are nondeductible dividend distributions. The parties presented conflicting arguments to us concerning the various considerations. Significantly, in light of *Elliotts, Inc.*, Slip Op. at 4685, whether the corporate profits represented a reasonable return on the shareholders' equity remains unresolved. A remand is appropriate to permit further consideration by the trial court in view of the teachings of *Elliotts, Inc.*

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

NO. 82-3588

DC# CV 80-350GF

M & K FARMS, INC., a Montana corporation,

Plaintiff-Appellant,

vs.

UNITED STATES OF AMERICA,

Defendant-Appellee.

ORDER

(Filed February 24, 1984)

Before: WRIGHT, KILKENNY, and BOOCHEVER, Circuit Judges.

The Petition for Rehearing and the En Banc Suggestion are denied. They have been circulated to all active judges of the court and none has requested a vote. Fed. R. App. P. 35(b). Judge Boochever would grant rehearing.

(Received February 27, 1984)

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